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Shariah Governance for Islamic Microfinance Industry

Tadbir Urus bagi Industri Kewangan Mikro Islam

Ibraheem Musa Tijani^{*}, Rusni Hassan^{**}, and Wan Amir Shafiq bin Ab. Nasir^{***}

Abstract

Microfinance is a growing industry that caters to various forms of financing for the financially underprivileged segment of any society. The microfinance industry aims to provide financial assistance to the poor, small and medium enterprises (SMEs), micro-entrepreneurs, and other financially marginalized segments. Although the microfinance industry continues to assist numerous people, its traditional mechanism of financing, interest-based deposits and interest-bearing loans (*riba*), is not permissible according to the Muslim belief. As an alternative, Islamic Microfinance was established to cater to the Muslim community. Islamic microfinance is increasingly becoming an effective mechanism to tackle poverty, inequality and provide financing to micro-entrepreneurs and small and medium enterprises (SMEs) in Muslim countries. However, for the integrity and credibility of the Islamic microfinance industry there is a need for good governance and regulations. Governance and regulation are still a major concern for both microfinance and Islamic microfinance. An added aspect of governance that is peculiar to the Islamic microfinance is Shariah governance. This paper will examine the possible means to establish Shariah governance for the Islamic microfinance industry. The paper is conceptual in nature and is based on literature review to support the theory of the research.

Keywords: Shariah Governance, Islamic Microfinance, Regulation.

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Abstrak

Pembiayaan mikro adalah industri yang berkembang serta memenuhi pelbagai bentuk pembiayaan untuk segmen masyarakat yang kurang bernasib baik. Industri pembiayaan mikro bertujuan untuk memberikan bantuan kewangan kepada golongan miskin, perusahaan kecil dan sederhana (PKS), pengusaha mikro, dan segmen lain yang terpinggir dari segi sektor kewangan yang utama. Walaupun industri pembiayaan mikro banyak membantu golongan tersebut, tetapi mekanisme pembiayaan tradisional yang diamalkan adalah berdasarkan deposit serta pinjaman dengan faedah (riba) yang tidak dibenarkan menurut Islam. Sebagai alternatif, pembiayaan mikro Islam ditubuhkan untuk memenuhi keperluan masyarakat Islam. Pembiayaan mikro Islam menjadi mekanisme yang berkesan untuk mengatasi kemiskinan, ketidaksamaan dan menyediakan pembiayaan untuk pengusaha mikro dan perusahaan kecil dan sederhana (PKS) di negara-negara Islam. Namun, untuk menaiktaraf integriti dan kredibiliti industri kewangan mikro Islam, peraturan mengenai tadbir urus yang baik adalah diperlukan. Secara umumnya, peraturan mengenai tadbir urus yang baik masih menjadi perhatian utama bagi kedua-dua sektor pembiayaan mikro dan pembiayaan mikro Islam. Walaubagaimanapun, bagi pembiayaan mikro Islam terdapat tambahan khusus di dalam aspek tadbir urus mereka iaitu aspek pematuhan Syariah. Kertas ini akan mengkaji cara untuk mewujudkan tadbir urus Syariah bagi industri kewangan mikro Islam. Kertas ini bersifat berbentuk konseptual dan menggunakan tinjauan literatur untuk menyokong teori penyelidikan yang dilakukan.

Kata Kunci: tadbir urus Syariah, kewangan mikro Islam, peraturan.

Introduction

Microfinance is a growing phenomenon throughout the world as a mechanism to alleviate poverty. The aspiration of microfinance is to eradicate poverty in the world. With great effort microfinance has grown beyond merely catering to the poor but also includes providing financial assistance to small and medium enterprises (SME), micro-entrepreneurs and anyone or entity excluded from the established financial system due to any reason. Microfinance is defined as “the provision of financial services to low-income clients, including self-employed, low-income entrepreneurs in both urban and rural areas” (Ledgerwood 1999, 1). It is also defined as a “small-scale financial services—primarily credit and savings—provided to people who farm or fish or herd; who operate small enterprises or microenterprises where goods are produced, recycled, repaired, or sold; who provide services; who work for wages or

commissions; who gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and to other individuals and groups at the local levels of developing countries, both rural and urban (Robinson 2001, 9).”

Microfinance should not be mistaken for micro-credits. Micro-credit is a component of microfinance and the main providers of micro-credits usually do so by: (i) lending to individuals on a non-profit (and often reciprocal) basis; (ii) lending directly but intermittent lending to individuals with a temporary surplus; (iii) lending to individuals specialized in lending, whether on the basis of their own funds or intermediated funds; (iv) individuals who collect deposits or ‘guard’ money; and (v) group finance (Hulme and Arun 2009, 187). As mentioned by Armendáriz and Morduch (2010, 15) microcredit was coined initially to refer to institutions like the Grameen Bank that were focusing on getting loans to the very poor. The focus was explicitly on poverty reduction and social change, and the key players were NGOs.” Microfinance includes financing for small businesses, micro-insurance, micro-entrepreneurs, micro-credit financing, micro-savings, etc. Microfinance works to develop alternative means of providing financing and create means of livelihood for the poor and micro entrepreneurs away from them resorting to begging and being vulnerable to exploitation. Microfinance activities usually involve: small loans, typically for working capital informal appraisal of borrowers and investments, collateral substitutes, such as group guarantees or compulsory savings, access to repeat and larger loans, based on repayment performance, streamlined loan disbursement and monitoring secure savings products (Ledgerwood 1999, 1). There are different types of microfinance facilities, microfinance banks, traditional commercial banks with microfinance operations, non-bank finance companies, self-help groups (SHGs) linked to commercial banks, co-operatives and community-based financial institutions dedicated to providing microfinance services to the poor, operate side by side in most countries.

For Microfinance, the person associated with initiating this industry in 1970’s was the 2006 Nobel Peace Prize co-recipient, Dr.

Muhammad Yunus. He was a lecture of economics in the United States of America before returning to his hometown Bangladesh. After seeing the misery and havoc that the money lenders “money-sharks” were causing in the area, he decided to take the initiative upon himself to help his poor neighbors. By this humble initiative, he was able to secure support from international communities. The program gained popularity and the model were later mimicked by other microfinance institutions globally. He delivered a very groundbreaking speech about possible outcome of microfinance in the future. He said:

I strongly believe that we can create a poverty-free world, if we want to In that kind of world, [the] only place you can see poverty is in the museum. When school children will be on a tour of the poverty museum, they will be horrified to see the misery and indignity of human beings. They will blame their forefathers for tolerating this inhuman condition to continue in a massive way. (Bateman 2010, 6)

His words and enthusiasm for the establishment of an industry that would cater to the poor spread quickly and his fame grew rapidly. However, time has change and no longer is it enough for the microfinance industry to offer a single product, such as a microloan for a small enterprise (Rhyne 2009, x). Hence, the industry cannot rely on merely lending, especially with the conventional microfinance that is complacent with just lending based on interest (*riba*). It was the high interest rates that caused some of the poor to even plunge deeper into poverty due to their inability to repay the debt and also in some cases their lack of skills. Although, Muhammad Yunus, when initiating microfinance in Bangladesh did it on low interest rate bases, nevertheless, he also admitted that the same institutions that we established to help the poor were now impoverishing them. Dr. Muhammad Yunus in his confession about this matter said: “I could never believed that the microfinance institutions have become the very same evil moneylenders that we attempted to replace” (Ayub 2015, 6).

There are still room for improvement and for effective mechanism to be in place that can reduce risk of the creditor and provide more financial services to assist the debtor. Ledgerwood (1999, 186) stresses on why there is a need for the microfinance industry to be better regulated and governed. She stated that being microfinance institutions are among the most informal and semiformal organisations providing financial services to microenterprises. Most of these institutions do not fall under the government regulations that are applied to banks and other formal financial institutions. Many nonbank microfinance institutions, especially non-governmental organisations, operate on the fringes of existing regulations, especially with regard to deposit mobilization (Ledgerwood 1999, 20). Another possible argument for the need for better regulation and governance of the microfinance industry is that big failure on a micro level will eventually cause an effect on the macro level and lead to instability and decline of the economy (Hulme and Arun 2009,186).

So, while there is regulatory and governance reform needed in the microfinance industry, the Islamic microfinance is not excluded from this reform. The Islamic microfinance is even less regulated and governed compared to the microfinance industry. A highly risky factor to the Islamic finance industry beyond other operational and regulatory risk is Shariah compliant risk. For example, although Muhammad Yunus is praised for his microfinance model in Bangladesh, his model would not be suitable for Islamic microfinance due to it being Shariah non-compliant. This is because his interest-based model is contrary to the tenet of Islam no matter how low the interest rate may be. Shariah prohibits interest (riba) in all its forms. Hence, another layer of governance, i.e. Shariah governance, is required to ensure that all the tenet of Shariah are adhered to and all the prohibitions are abstained from. Below the authors will shed briefly on some of the prohibitions in the Shariah that occurs in the microfinance industry.

Prohibitions in Shariah

Microfinance has created numerous success stories and assisted many people globally, especially those in the developing countries including Muslim countries. However, it has limitations in penetrating deeply into the Muslim societies due to its noncompliance to some Islamic principles. Some Muslims in these countries might engage with the conventional microfinance, however, they would be doing so with an uneasy heart or due to necessity. As mentioned by Rahman (2015), these types of Muslims suffer the worst being that they are subjected to the exploitation of the interest based microfinance and at the same time the guilt at heart knowing that they are committing a sin by indulging in *riba*.

A major component of the conventional microfinance that is heavily prohibited in the Muslim belief is the charging of interest on loans (a component of *riba*), which is a fundamental principle of conventional microfinance. *Riba*, which literally means addition, growth or elevation, can be technically defined as “any excess compensation without any corresponding counter-value recognized by the Shariah (ISRA 2010, 66). *Riba* is of two forms: *Riba al-duyun* (usury/interest on credit), which has two components *riba al-qard* (interest on loan) and *riba al-nasi'ah* (interest on debt); and *riba al-buyu'* (usury/interest in sales), which also has two components *riba al-fadl* (unequal amount in an exchange contract) and *riba al-nasi'ah* (interest based on deferment). These forms of *riba* are all prohibited in the Shariah; hence, any aspect of this would deem the financial transaction Shariah non-compliant. Hence an interest-bearing micro loan that is extended to a farmer to be utilized for cultivating crops would be considered prohibited. This is because according to the Islamic principle, loan (*qard*) is a benevolent act which should not generate or include any excess. Based on the example mentioned above, the loan extended to the farmer should not include any addition beyond the amount that was extended to the farmer. Therefore, the simplest alternative to the interest-bearing loan in microfinance is interest free loan (*qard al-hasan*). This concept will be further explained in the Islamic microfinance model below. The prohibition for *riba* is clear in all Islamic primary sources, i.e., the Quran and hadith (traditions

of Prophet Muhammad (peace be upon him)). The Quran states: "Those who take *riba* (usury or interest) will not stand but as stands the one whom the demon has driven crazy by his touch. That is because they have said: "Sale is but like *riba*", while Allah has permitted sale, and prohibited *riba*." (Quran, 2: 275). As for the Hadith the prophet (peace be upon him) said: "All of the *riba* of Jahiliyyah is annulled. The first *riba* that I annul is our *riba*, that accruing to 'Abbas ibn 'Abd al-Muttalib [the Prophet's uncle]; it is being cancelled completely." (Muslim 1995, 2:886). The texts on the prohibition of *riba* are numerous. Therefore, the practice on *riba* in microfinance in the form of interest-bearing loans, or micro-financing with embedded interest or small deposits generating interest and the likes are all prohibited in the Shariah.

Gharar is another prohibited element in Islam. It is narrated by Abu Hurayrah that "the Messenger of Allah forbade pebble sales and sales that involve *gharar*" (Muslim, 1995, 5:127, hadith No. 1513). *Gharar*, which means uncertainty or ambiguity, is "something for which the probability of getting it and not getting it are about the same, some said: something whose acquisition is uncertain, and its true nature and quantity are unknown" (ISRA 2010, 131). *Gharar* has three forms: *gharar fahish* (excessive uncertainty), *gharar mutawasit* (moderate uncertainty) and *gharar yasir* (minor uncertainty). Minor *gharar* is acceptable in *Shariah*. Moderate *gharar* is evaluated on case to case basis of whether acceptable or prohibited. However, excessive *gharar* is prohibited in *Shariah*. There are a number of ways in which *gharar fahish* may occur: a. Uncertainty or risk related to existence; b. Uncertainty or risk related to taking ownership; c. Uncertainty or risk related to quantity; d. Uncertainty or risk related to quality; and e. Uncertainty or risk related to the time of payment.

Gharar occurs in the microfinance industry in the aspect of microinsurance. Micro-insurance is a mechanism meant to protect low-income earners against specific perils in exchange for regular premium payments proportionate to the likelihood and cost of the risks involved. It is mainly designed for people ignored by mainstream commercial insurance models. They lack access to appropriate services because they

work in the informal economy and have no predictable streams of income (Mikail, Ahmad and Ansary 2017, 5-6). The services are similar to insurance, that it provides general and life insurance facilities at the microlevel. The element of *gharar* occurs in microfinance being that the policyholders are paying for a premium that may or may not occur. From the Shariah perspective, a sale contract, as in the case of conventional microinsurance, should not contain major *gharar*, i.e., the item being sold should be specified and the delivery date of the purchased item should be specified and agreed upon by both parties. Hence, the need for a *Shariah* complaint alternative that Muslims could subscribe to, which is micro-takaful.

Another prohibited element that is embedded in microinsurance is *maysir* (gambling). *Maysir* literally means “any activity which involves betting whereby the winner will take the entire bet and the loser will lose his bet. It means games of pure chance where any party might gain at the expense of the loss of the other party” (ISRA 2011, 183). *Maysir* occurs in microinsurance, which is similar to normal insurance, in the aspect that policyholders pay for premium in the event if anything occurs, the insurer will make payment. Hence, in the case an insured event occurs policyholders will be able to claim on their bet but if nothing happens the money will not be returned to the policyholder.

These are a few of the main prohibitions of the *Shariah* that occurs in the microfinance industry that makes the industry unattractive to Muslims. However, *Shariah* non-compliant may occur in various other means beyond these mentioned prohibitions, whether it is due to the mode of financing, or the underlying asset or the manner in which the contract was concluded, or product structure and many other methods. Hence, there is a need not only for establishing an alternative industry to microfinance but also an effective mechanism to ensure that *Shariah* requirements are well preserved and governed in such industry.

An alternative: Islamic microfinance

Based on the above prohibitions and practices in the microfinance industry there is sufficient justification for an alternative industry that

provide similar services and in line with *Shariah* principles. This gave birth to the establishment of Islamic microfinance industry. The Islamic microfinance inherently drives on the success of two rapidly growing industry, i.e., microfinance and Islamic finance (IF).

The growth and development of the microfinance industry has already been explained above. As for the growth of the Islamic finance (IF) industry, it was also due to the demand of Muslims for an alternative financial system that was compatible to the Islamic belief. The IF industry is driven by not only by faith but ethical and social dimension along with risk-sharing concepts. However, the Islamic finance industry catering to the needs at the time in establishing a global industry focused strongly on developing the Islamic banking, *takaful* (Islamic insurance) and Islamic capital market. There was indeed very strong demand for these sectors in the Muslim world and IF industry manage to secure for itself as a credible alternative to its conventional counterpart. The IF industry in these sectors grow to the extent that non-Muslim countries have accepted the genuine drive and ambition of the industry and made regulatory changes to accommodate its development in those jurisdictions.

Similar to the conventional counterpart, a large segment of the Muslim society felt marginalized due to being excluded from the Islamic financial system. However, unlike the conventional system, there was already in place an Islamic structure that was catering to this segment of the society, but they were not well structured. This is in reference to the *zakat* and *waqf* system that was established by Islam to cater to the poor and underserved in the society. Hence, the Islamic microfinance can use these mechanisms and others to play a vital role to create opportunities and facilities for these marginalized people, both Muslims and non-Muslims alike. There are an estimated 650 million Muslims living on less than \$2 a day (Rhule 2016, 12). This is one-third of the Muslim population in the world. These are the people that the Islamic microfinance would be serving through its services and financing. There are growing number of Islamic microfinance institutions that are supporting by providing various *Shariah* compliant facilities for these

marginalized through various Islamic products, such as *zakat*, *waqf*, *qard al-hasan*, and other Islamic contracts. While this is indeed encouraged, the question is how these Islamic microfinance institutions are regulated and governed.

The issues and challenges of regulation and governance of the microfinance industry have been widely discussed. These issues and challenges are also akin to the Islamic microfinance industry. There are various discussions on these matters such as, profitability, performance, performance in Central and Eastern Europe, regulating and supervising, female leadership, sustainability regulatory approaches and other issues and challenges. However, being that Shariah is unique to the Islamic microfinance industry, the issue of Shariah governance in the Islamic microfinance industry has not received much attention although literature shows that *Shariah* governance is the backbone of the entire Islamic finance industry (Cull, R., Demircuc-Kunt, A.L., & Morduch, J. 2009; Mersland, R., & Strøm, R.S. 2009; Hartarska, V.M. 2004; Strøm, R.S., D’Espallier, B., & Mersland, R. 2014; Ayayi, A., & Sene, A.G. 2010; David Hulme & Thankom Arun 2009; Rusni Hassan, Nurdianawati Irwani Abdullah & alts n.d.; Rodney Wilson 2009; Sherin Kunhibava 2015).

Findings and Discussion

Islamic Microfinance Models

Islamic microfinance institutions have the opportunity to use various modes of financing other than the *Shariah* non-compliant instruments of interest-bearing loans or interest-based deposits to provide financing for its participants. As mentioned above, due to specific *Shariah* prohibitions such as *riba*, *gharar*, *maysir* and others, Islamic microfinance will need to ensure that financing models are in compliance with the Shariah. A possible approach for the IMF industry is to adopt some of the existing Islamic financing models that are offered by Islamic banks to its customers which could be suitable for the Islamic microfinance industry. The IMF instruments are not expected to be completely different from the instruments offered by the Islamic banking

industry. However, due to the nature of Islamic microfinance, not every instrument offered in Islamic banking is suitable, even though Shariah compliant, for the IMF industry. As mentioned by Dusuki (2008, 56), Islamic microfinance instruments can be divided into two forms of resources, internal and external. Internals refers to funding that can be sourced internally for the sustainability of the institution which includes: a) deposits such as *wadiah* (safekeeping), *qard al-hasan* (benevolence loan) and other Islamic financing contracts such as *murabahah* (mark-up sale), *ijarah* (lease); and b) equity through participatory models such as *musharakah* (partnership) and *mudarabah* (profit sharing partnership). External refers to funding that can be sources from external parties, this can include *waqf* (endowment), *zakah* (compulsory alms), *sadaqah* (charities), and other forms of donation.

A popular instrument in the Islamic microfinance industry, under the internal resources, is *qard al-hasan*, which is used by various IMF institutions. This is because *qard al-hasan* is highly recommended in the *Quran* as a noble act. Allah says: “Who is he that will give Allah *qard al-hasan* (benevolent loan)? For Allah will increase it for him and he will have a noble reward” (Quran, 57:11) and “If you give Allah *qard al-hasan* (benevolent loan), He will multiply it for you and grant you forgiveness. Allah is most Appreciative and Forbearing.” (Quran, 67:17). Therefore, *qard al-hasan* is stressed upon as an act of piety and praiseworthy. This is an interest free loan model that does not generate any form of profit or return. *Waqf* (endowment), *zakah* (compulsory alms) and *sadaqah* (charities) are also widely relied upon in the Islamic microfinance industry. These Islamic instruments are fundamentally meant for the poor and needy in the society. As for the equity through participatory models, they are been offered by Islamic microfinance institutions to micro entrepreneur and SMEs to support their initiatives.

The Need for Shariah Governance

The main essence of Shariah governance is to maintain the confidence and trust of the stakeholders on matters related to Shariah. As stated by (Hassan et al. 2014, 10), “the foundation for the practice of

Islamic finance is observance of the doctrines, conditions and principles laid down by the *Shariah*. Comprehensive compliance with *Shariah* principles would bring confidence to the public and financial markets on the credibility of Islamic finance operations.” This is equally applicable to the Islamic microfinance industry. Shariah governance is a core pillar of Islamic finance and its importance should be treated in the same manner in all aspect of the Islamic financial industry, whether it is Islamic banking, or takaful, or Islamic capital market, or Islamic microfinance, or Islamic fintech, or etc. Islamic microfinance faces various challenges and obstacles. Abdul Rahman and Dean (2013) highlighted on some of the major challenges and place them into four categories: market penetration, sustainability of Islamic MFIs, high transaction costs, and the effectiveness of Islamic MFIs in alleviating poverty. The challenges are mainly on the operational aspect of the Islamic finance institutions, which are duly important. However, the focus in the paper is on the regulatory and governance challenge, which can be considered extremely crucial for the foundation of any industry.

The Islamic Financial Services Board (IFSB) in its Technical Note on Financial Inclusion and Islamic Finance echoed similar interest for both financial inclusion and microfinance activities in regard to regulation and *Shariah* governance. It states:

Both deposit-taking and non-deposit-taking institutions will also need regulations—in particular for non-prudential issues—in terms of consumer protection, financial literacy, financial reporting and transparency, as well as know-your-customer (KYC) rules and financial crime risk management. Given specifics from *Shariah* law, these institutions require appropriate adjustments in business processes in the form of *Shariah* governance requirements to ensure that non-prudential regulatory issues are soundly addressed (IFSB 2019, 15)

Shariah governance is necessary to be independent by itself but rather it could be addressed within the regulatory guidelines for Islamic microfinance. Islamic microfinance is being practiced in various countries and yet still only a hand full of countries have guidelines on Islamic microfinance; notable Guidelines for Islamic Microfinance

Business by Financial Institutions issued by State Bank of Pakistan and Guidelines on the Regulation and Supervision of Non-Interest (Islamic) Microfinance Banks in Nigeria issued by Central Bank of Nigeria. Also due to the global crises of war and financial difficulties, even non-governmental organizations (NGOs) are offering Islamic microfinance facilities, such as *zakah* and *sadaqah* to Muslim victims. With the growing number of institutions that are not under the formal regulatory bodies offering various *Shariah* complaint facilities, it begs to ask how their products are vetted and approved to be *Shariah* compliant.

Let's take for example Akhuwat Islamic Microfinance (AIM) of Pakistan, which has done commendable work in the Islamic microfinance industry and worthy of emulating. As of 31st December 2019, Akhuwat has an outstanding loan portfolio of Rs. 16.8 billion (USD 109 million), 865,548 active loans, and total disbursed loans of Rs. 102 Billion (USD 660 million). With this high volume of activities in the Islamic microfinance industry, *Shariah* compliant is not mentioned in the loan process nor is there any *Shariah* unit in the organizational structure of the institutions (Akhuwat Islamic Microfinance 2019). Similarly, under the board of directors, there is mention of the institution being governed by members that are philanthropists, civil servants and businessmen but nothing mentioned about *Shariah* scholars or advisors. Although it may be argued that the institution only offers *qard al-hasan* financing to clients. However, due to the very strict nature of *Shariah* on loans, it is even more important to show that a proper *Shariah* guideline and governance are in place to ensure the procedure and financing is *Shariah* compliant throughout the whole process.

Shariah Governance in Islamic Microfinance

The Islamic Financial Services Board (IFSB), an international standard setting body, in its Guiding Principles on *Shariah* Governance Systems for IIFS (IFSB-10) defined *Shariah* Governance System as “the set of institutional and organizational arrangements through which an IIFS ensures that there is effective independent oversight of *Shariah* compliance over each of the following structures and processes:

- (a) Issuance of relevant Shariah pronouncement resolutions
- (b) Dissemination of information on such Shariah pronouncements/resolutions to the operative personnel of the IIFS who monitor the day-to-day compliance with the Shariah pronouncements/resolutions vis-à-vis every level of operations and each transaction.
- (c) An internal Shariah compliance review/audit for verifying that *Shariah* compliance has been satisfied, during which any incident of non-compliance has been satisfied, during which any incident of non-compliance will be recorded and reported, and as far as possible, addressed and rectified, and
- (d) An annual Shariah compliance review/audit for verifying that the internal Shariah compliance review/audit has been appropriately carried out and its findings have been duly noted by the Shariah board.”

Being that IFSB oversee not only the Islamic banking and Takaful industry, but the entire Islamic financial industry, this definition can be read broadly to include Islamic microfinance. Hence, this section would expand on the *Shariah* governance definition and put the structures and process in the context of Islamic microfinance.

- (a) Issuance of relevant Shariah pronouncement resolutions.

This is to ensure that proper Shariah pronouncements/resolutions are obtained from the authorized Shariah board or council by the Islamic microfinance institutions. This may occur by the government or central banks of these countries to establish Shariah boards that would cater to the Islamic microfinance to ensure that the products are compliant to the Shariah. After the Shariah board members have deliberated rigorously on the matter, the board can then endorse by providing Shariah pronouncement or resolution on the product. This will aid to ensure that the Shariah pronouncements are centralized.

- (b) Dissemination of information on such Shariah pronouncements/resolutions to the operative personnel of the IIFS who monitor the day-to-day compliance with the

Shariah pronouncements/resolutions vis-à-vis every level of operations and each transaction.

The Islamic microfinance institution should consider incorporating this into their institution policy or guideline to ensure that their day-to-day activities are in line with the Shariah. This can be done by either appointing a designated staff or embed it within the structure to a qualified staff that is capable of monitoring the Shariah pronouncements/resolutions of the institution.

- (c) An internal Shariah compliance review/audit for verifying that Shariah compliance has been satisfied, during which any incident of non-compliance has been satisfied, during which any incident of non-compliance will be recorded and reported, and as far as possible, addressed and rectified, and

This process, similar to the one above, can be considered to be carried out by an existing competent staff within the Islamic microfinance institution. Another approach, as proposed in the technical note of IFSB, is either to outsource the review/audit process, which might be less costly than to hire a new staff or in the form of CSR or pro bono from Shariah Advisers, Shariah Advisory firms or Shariah boards of firms. These approaches take into consideration the financial constraint that is already facing most IMF institutions. Shariah review should be maintained on a periodic basis to ensure that the Shariah is strictly adhered to within the institution. The regulators can render support in this aspect by assisting the existing staff to acquire the necessary knowledge on basic of Shariah compliant products and services to carry out the duties of the institution.

- (d) An annual *Shariah* compliance review/audit for verifying that the internal Shariah compliance review/audit has been appropriately carried out and its findings have been duly noted by the Shariah board.

This process is sometimes very costly for general financial institutions, so it might be a burden for IMF institutions. Hence, for the IMF industry this process should be under the purview of the regulator. The regulator can assign an independent government linked company

(GLC) as an external *Shariah* review/audit for Islamic microfinance institutions. This will ensure the independence of the Shariah auditor/reviewer of the regulator, while also allowing the cost to be borne by the government.

The IFSB Technical Note (TN) however states the following regarding the application of the IFSB standard 10: Guiding Principles on Shariah Governance Systems for IIFS on the activities of financial inclusion [including Islamic microfinance]: “this TN has recognised certain exceptions and allowed proportionate regulatory flexibilities, and takes precedence over IFSB-10 only for such specified activities (i.e. financial inclusion activities as defined in this TN). This, however, does not override any existing guidelines and/or more stringent practices as already adopted by national RSAs, particularly if the service provider is a prudentially regulated institution under a national/central Shariah governance framework of the jurisdiction.”

Conclusion

Islamic microfinance has the potential to serve millions of Muslims who are financially marginalized due to various obstacles, especially provisions that violate their religious principles. There is a huge market that is waiting for the development and strong governance of the Islamic microfinance industry. Shariah compliance is a strong component of the acceptability of any Islamic financial facility, which includes Islamic microfinance. Hence, having Shariah governance in place would only hasten the acceptability and increase the credibility of the industry to the Muslim masses. Everyone, including scholars and corporates should make effort to ensure that this financial, regulatory and governance issues of the industry is catered to, which will then aid the development of the industry to better assist the weak and vulnerable of the society. As the Prophet rightly said: “Seek out the vulnerable among you. Verily, you are only given provision and victory due to your support of the weak amongst you.”

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